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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 130

BESSIE P. DOUGLAS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 131

BESSIE P. DOUGLAS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 132

ESTATE OF CHARLES H. ROBINSON, NORTHWESTERN NATIONAL BANK AND TRUST COMPANY OF MINNEAPOLIS, JESSIE P. ROBINSON, ET AL., ETC., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

No. 133

BERNICE B. DALRYMPLE, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the Board of Tax Appeals (R. 44–53) is reported at 46 B. T. A. 943. The opinion of the Circuit Court of Appeals (R. 75–82) is reported at 134 F. 2d 762.

JURISDICTION

Judgments of the Circuit Court of Appeals were entered on April 7, 1943 (R. 83–85). A petition for writs of certiorari was filed July 1, 1943, and granted on January 10, 1944 (R. 85–86). Jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the amounts equal to the total deductions taken by each of the taxpayers, as lessors, for depletion on advance royalties under mining leases in the years when such royalties were received, should be included in gross income in a later year when the leases were terminated without any ore having been mined.

2. Whether any part of such amounts should be excluded from income on the ground that no tax benefit was received in the year in which the deductions were taken.

STATUTES AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in Appendix A, *infra*, pages 40–45.

STATEMENT

The Board of Tax Appeals adopted as its findings of fact (R. 45–47), the stipulated facts (R. 36–43). They may be summarized as follows:

On July 1, 1929, Bessie P. Douglas, Adeline R. Morse, Charles H. Robinson, and Irene B. Robinson Cirkler owned an iron ore mine situated in St. Louis County, Minnesota, known as the "Pettit" mine. Bessie P. Douglas owned an undivided one-half interest in the mine and each of the others, an undivided one-sixth interest. Robinson, who died August 16, 1932, and Mrs. Cirkler, who died on October 20, 1937, still owned their interests in the property at the time of death. Robinson's estate is in process of administration, the Northwestern National Bank of Minneapolis, Jessie P. Robinson, and Charles J. Robinson being coexecutors. Mrs. Dalrymple is transferee of all of the assets of Mrs. Cirkler. (R. 17, 18, 19, 26, 27, 45, 46.)

In 1929 the four owners leased the mine to the Republic Steel Corporation for a term of thirty years beginning July 1, 1929. The lease provided that minimum royalties should be paid annually whether any ore was extracted during the

year or not. Such royalties were to be applied on ore later mined and shipped. The lease also provided for its cancellation by the lessee, and in 1937, pursuant to such provision, the Republic Steel Corporation cancelled the lease without having removed any ore from the mine during the existence of the lease. (R. 46.)

From the execution of the lease until termination, the lessee paid the agreed advance royalties to the lessors or their successors. The lessors or successors in filing their income tax returns, which were prepared on the cash basis, reported in their gross incomes for the respective years the royalties received and took deductions for depletion with respect to such royalties. The deductions thus taken were computed on a cost basis and allowed by the Commissioner. (R. 46.) The amounts of advance royalties reported in income and depletion taken by the taxpayers and allowed by the Commissioner, were as follows (R. 37–43):

Year	Douglas		Robinson		Cirkler	
	Royalties	Depletion	Royalties	Depletion	Royalties	Depletion
1929	$2,500.00	$1,239.51			$833.33	$413.19
1930	15,000.00	4,968.05			3,333.33	1,652.75
1931	10,000.00	4,968.05			3,333.33	1,652.75
1932	10,000.00	4,968.05	$833.33	$413.19	3,333.33	1,652.75
1933	10,000.00	4,968.05	3,333.32	1,176.00	3,333.33	1,652.75
1934	12,500.00	6,197.56	4,166.66	2,065.94	5,000.00	2,479.13
1935	22,500.00	11,155.61	7,500.00	2,646.01	7,500.00	3,718.69
1936	30,000.00	14,874.15	10,000.00	3,528.00	10,000.00	4,958.25

In determining the deficiencies, the Commissioner, pursuant to Article 23 (m)–10, Treasury Regulations 94, treated as gross income for 1937 the aggregate of the depletion deductions claimed by, and allowed to, the taxpayers for the years prior to and including 1936, with respect to the minimum royalties received by them for the lease on the Pettit mine (R. 46–47).

In 1933, Bessie P. Douglas had a net loss of $13,947.51. In that year she took a depletion deduction with respect to the advance royalties in the amount of $4,958.05. (R. 50.)

The Board held that the regulations on which the Commissioner relied are valid and that all the depletion deductions taken in prior years were properly included by the Commissioner as taxable income with the exception of $4,958.05 in the case of Bessie P. Douglas, because as to that amount she had received no tax benefit (R. 47–53). Accordingly, the Board found deficiencies in income taxes for 1937 against Bessie P. Douglas in the amount of $26,977.56 (R. 53); against the estate of Charles H. Robinson in the amount of $1,532.38 (R. 54); and against Bernice B. Dalrymple, as transferee of the estate of Irene B. Robinson Cirkler, deceased, in the amount of $5,412.47 (R. 54–55).

The Circuit Court of Appeals affirmed the Board's decision on the first issue but reversed the Board on the second issue involving only

Mrs. Douglas, and held that she must include also the sum of $4,958.05 in income for the taxable year (R. 81–82).

SUMMARY OF ARGUMENT

I

As petitioners concede, Article 23 (m)–10 (c) of Treasury Regulations 94 requires that amounts equal to the depletion deductions taken on minimum royalties received by them in prior years as lessees under their mining lease, be included in taxable income in the year when the lease was terminated without minerals having been extracted.

The regulation is valid. It was adopted under Section 23 (m) of the Revenue Act of 1936, which provides for a reasonable allowance for depletion under rules and regulations to be prescribed by the Commissioner. Thus it has the force of law by express delegation of Congress. Moreover, an identical provision has been in the regulations since 1919, during which time the statute has been reenacted nine times. The implication arising from reenactment that Congress has approved the regulation is particularly applicable where, as here, the statute expressly requires that a detailed scheme to effectuate its ends be established by administrative regulations. In consequence, the regulation is entitled to the utmost respect because it is the administrative solution, long ap-

proved by Congress, of the "highly technical and involved" depletion problem.

The reasonableness of the regulation is evidenced by the fact that the Tax Court and the Circuits Courts of Appeals for the Fifth and Eighth Circuits expressly, and this Court, in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, by implication, have approved it. Under the regulation, a depletion deduction is allowed for the anticipated wasting of a capital asset conditioned on treating as income amounts equal to the deduction when it becomes known, as by the cancellation of a lease without extraction of ore, that the amounts are income and not a return of capital because there will be no diminution of capital. The reasonableness of this treatment is demonstrated by the similar result reached independently of a regulation in analogous situations.

The provision of Section 23 (m) requiring a revision of prior estimates of the number of recoverable units in light of information obtained by operations but prohibiting an adjustment of basis has no application to the situation here. This is confirmed by the reason for prohibiting an adjustment of basis in the statutory situation and the necessity of adjusting basis under the circumstances of this case as provided in the regulation as well as by the legislative history. Such adjustment is not contrary to Section 113 of the statute but is clearly within the authorization provided by Section 113 (b) (1) (A).

II

The Board, in concluding that an amount equal to the depletion deduction taken by Mrs. Douglas in 1933, which did not effect a tax saving, was not income in the year of cancellation of the lease, held contrary to the regulation. Since the regulation provides that an amount equal to "depletion deductions made in prior years" be returned as income, there is no basis for tax-benefit qualification.

Petitioners' reliance on *Dobson* v. *Commissioner*, Nos. 44–47, decided December 20, 1943, rehearing denied February 14, 1944, not yet reported, is unfounded, because in that case this Court did not adopt the tax-benefit theory but merely held that the Tax Court was free to do so in the absence of a controlling regulation. Every consideration advanced by this Court to give finality to the Tax Court in the situation presented by the *Dobson* case applies with equal force to the regulation here.

Since the justification for treating as income when the lease is cancelled amounts equal to depletion deductions formerly taken is that at that point its status as profit is first known, there is no reason for eliminating amounts from income equal to depletion deductions that did not effect a tax saving. Even without the regulation the Board's conclusion is without foundation because it treated the problem as if a loss recovery were.

involved. Such treatment completely fails to fit the facts of this case.

ARGUMENT

I

ARTICLE 23 (m)-10 (c) OF REGULATIONS 94, REQUIRING THAT AMOUNTS EQUAL TO DEDUCTIONS FOR DEPLETION ON ADVANCE ROYALTIES UNDER MINING LEASES TAKEN BY THE LESSORS IN PREVIOUS YEARS BE REPORTED AS GROSS INCOME IN 1937 WHEN THE LEASES WERE TERMINATED WITHOUT ORE HAVING BEEN EXTRACTED, IS VALID

1. The Commissioner determined, the Board of Tax Appeals and the Circuit Court of Appeals for the Eighth Circuit held and petitioners concede that the Treasury Regulations plainly require that amounts equal to the total deductions taken by them in previous years for depletion on advance royalties should be included in gross income in 1937 when the leases were terminated without the extraction of ore. Article 23 (m)-10 (c) of Treasury Regulations 94 (Appendix A, *infra*, p. 43), provides that—

> If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, *and a corresponding amount must be returned as income for the year in which*

the lease expires, terminates, or is abandoned. [Italics supplied.]

This regulation was promulgated under Section 23 (m) of the Revenue Act of 1936 (Appendix A, *infra*, p. 40) which provides for a reasonable allowance for depletion under rules and regulations to be prescribed by the Commissioner and is, threfore, a "legislative",[1] as opposed to an "interpretative", regulation.[2] See *Burnet* v. *Thompson Oil & G. Co.*, 283 U. S. 301, 305. As such the regulation has the same effect as if its language were contained in the statute[3] (*Avent* v. *United States*, 266 U. S. 127; *United States* v. *Grimaud*, 220 U. S. 506; *Titsworth* v. *Commissioner*, 73 F. 2d 385 (C. C. A. 3d)), subject only to the qualification that the Commissioner must not have exceeded the authority delegated.

That the Commissioner has stayed within his authority is strongly implied by the fact that in the 25 years of the existence of Article 23 (m)–

[1] Alvord, Treasury Regulations and the Wilshire Oil Case, 40 Colum. L. Rev. 252, 259 (1940); Griswold, A Summary of the Regulations Problem, 54 Harv. L. Rev. 398, 400 (1941); Lee, Legislative & Interpretive Regulations, 29 Georgetown L. J. 1 (1940).

[2] "Interpretative" regulations are authorized under Section 62 of the Revenue Act of 1936, which provides that—

"The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this title."

[3] The constitutionality of delegation of legislative power of this nature has long been recognized. *Field* v. *Clark*, 143 U. S. 649; *Buttfield* v. *Stranahan*, 192 U. S. 470.

10 (c) or its counterpart in other Regulations,[4] its validity has been relatively infrequently challenged and has consistently been sustained by the courts and also by the Board of Tax Appeals.[5]

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[4] See footnote 6, *infra*.

[5] The early decisions of *Knapp* v. *Commissioner*, 7 B. T. A. 790 (Acq. VII–1 Cum. Bul. 17), and *Cooper* v. *Commissioner*, 7 B. T. A. 798 (Acq. VII–1 Cum. Bul. 7), relied on by petitioners (Br. 9–10) as contrary to these decisions, are distinguishable. The Board treated these cases as if all of the depletion for the years prior to the termination of the lease in 1919 had been taken under Section 5 (a) Eighth (b) of the Revenue Act of 1916, c. 463, 39 Stat. 756, authorizing a depletion deduction "not to exceed the market value in the mine of the product thereof, *which has been mined and sold during the year* for which the return and computation are made" (italics ours). Under this provision depletion could not be deducted in advance of production, whereas the underlying assumption of the regulation herein involved, first promulgated as Art. 215 of Regulations 45 (1919 Ed.), is that depletion is deductible in advance of production. The advance depletion allowed by the Commissioner was thus unlawfully deducted, whereas the regulation was intended to apply to depletion lawfully deducted but proved excessive by subsequent events. Under the statute involved the termination of the lease without production was consequently a wholly irrelevant circumstance, and the Board's conclusion that it could not be made the occasion for adding back to income an amount equal to the unlawful deductions could not be condemned. The Commissioner's acquiescence in these decisions (VII–1 Cum. Bul. 7, 17) thus cannot be taken as meaning, as petitioners urge, that he viewed the regulation as invalid under the Revenue Act of 1918 and subsequent acts under which advance depletion is properly deductible (*Murphy Oil Co.* v. *Burnet*, 287 U. S. 299). This conclusion is reinforced by the fact that in Regulations 77, Art. 236, he promulgated a regulation substantially identical to that involved in the *Knapp* and *Cooper* cases. The date of these regulations was February 15, 1929, about eighteen months after those deci-

Lamont v. *Commissioner* and *Shawmut Co.* v. *Commissioner* (decided contemporaneously), 120 F. 2d 996 (C. C. A. 8th); *Sneed* v. *Commissioner*, 119 F. 2d 767 (C. C. A. 5th), rehearing denied, 121 F. (2d) 725 (C. C. A. 5th), certiorari denied, 314 U. S. 686; *Barnett* v. *Commissioner*, 39 B. T. A. 864; *Houston Farms Development Co.* v. *United States* (S. D. Texas), decided January 13, 1942 (1942 C. C. H., par. 9374), decided on another point, 131 F. 2d 577 (C. C. A. 5th). Cf. *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299.

Congress, too, may be said to have approved the way in which the delegated authority has been exercised. A provision identical with Article 23 (m)–10 (c) of Regulations 94 has been in the regulations since 1919 when Regulations 45, Article 215, was adopted pursuant to Section 214 (a) of the Revenue Act of 1918 and has appeared in all income tax regulations thereafter issued. Yet Congress has reenacted the provision delegating authority to the Commissioner to provide a "reasonable allowance for depletion" in nine Revenue Acts without regard to the several Revenue Acts amending the Code.[4] Frequently this Court has

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sions and about twelve months after the Commissioner's acquiescence in them. This acquiescence was withdrawn in 1932 (XI–2 Cum. Bull. 12, 14). In G. C. M. 941, VI–1 Cum. Bull. 205 (1927) it is expressly stated that a precedent established by acquiescence in a Board decision is only binding where the facts in the two cases are identical.

[4] In addition to Regulations 45, Article 215, the provision appeared thereafter in Regulations 62, Article 215, issued

declared in situations involving "interpretative" regulations of long standing that they acquire the force of law through reenactment of the statute substantially unchanged (*Helvering* v. *Reynolds Co.*, 306 U. S. 110; *Helvering* v. *Winmill;* 305 U. S. 79, 83; *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459, 466), because Congressional approval of the interpretation is implied from reenactment (*National Lead Co.* v. *United States*, 252 U. S. 140, 146–147). The rule is *a fortiori* applicable to this, a "legislative" regulation,[7] be-

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under Section 214 (a) of the Revenue Act of 1921; Regulations 65 and 69, Article 216, issued under Section 214 (a) of the Revenue Acts of 1924 and 1926; Regulations 74, Article 236, issued under Section 23 (l) of the Revenue Act of 1928; Regulations 77, Article 230, issued under Section 23 (l) of the Revenue Act of 1932; Regulations 86, 94, and 101, Article 23 (m)–10, issued under Section 23 (m) of the Revenue Acts of 1934, 1936, and 1938; and Regulations 103, Section 19.23 (m)–10 and Regulations 111, Section 29.23 (m)–10, issued under the Internal Revenue Code, Section 23 (m). Article 215 of Regulations 45 (1920 ed.) made certain changes in Article 215 of Regulations 45 (1919 ed.) and in turn was amended by T. D. 3938, V–2 Cum. Bull. 117 (1926). See *Murphy Oil Co.* v. *Burnet*, *supra*. But the provisions dealing with the question here involved were not substantially changed.

[7] The Court has applied the reenactment doctrine in approving at least three "legislative" regulations dealing with depletion. *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299; *Burnet* v. *Thompson Oil & G. Co.*, 283 U. S. 301; cf. *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90. The *Murphy Oil Co.* case approved an integrally related section of the similar provision of Regulations 45, Article 215, under the 1918 Revenue Act. See discussion, p. 21, *infra*. In *Burnet* v. *Thompson Oil &*

cause of the greater probability that the responsible individuals in the legislative process were familiar with it since Section 23 (m) takes so much of its substance from the regulations. It may be said then with reality that if there were doubt as an original proposition whether the Commissioner has stayed within the bounds of his delegated authority, it has been dissipated by nine reenactments of the statute unchanged.[8] See Feller, Addendum to the Regulations Problem, 54 Harv. L. Rev. 1311, 1321 (1941).

But there is a more important reason for affording deference to this regulation than reenactment of the statute in itself. That consideration is stated as follows in *Helvering* v. *Wilshire Oil Co.*, 308 U. S. 90, 103:[9]

> In sum, the highly technical and involved factors entering into a practical solution of

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G. Co., supra, another regulation adopted under the 1918 Act was approved. The *Wilshire* case approved a regulation adopted under Section 23 (l) of the Revenue Act of 1926, containing the identical rule-making authority as Section 23 (m) of the Revenue Act of 1936, here involved.

[8] The situation is comparable to an express Congressional ratification of an unlawful exercise of delegated power. *Swayne & Hoyt, Ltd.*, v. *United States*, 300 U. S. 297.

[9] Sound administration of a complex law as justifying great weight to be attached to regulations has also been emphasized by commentators. Griswold, A Summary of the Regulations Problem, 54 Harv. L. Rev. 398 (1941); Paul, Studies in Federal Taxation (Third Series, 1940) 420; Brown, Regulations, Reenactment, and the Revenue Acts, 54 Harv. L. Rev. 377 (1941).

> the problem of depletion in administration of the tax laws points to the necessity of interpreting § 23 (1) so as to strengthen rather than to weaken the administrative powers to deal with it equitably and reasonably. These considerations are persuasive here not only in reaffirming the conclusion that the rule-making power existed, but also in concluding that restrictions on that power should not be lightly imposed where the incidence of such rules as are promulgated is prospective only.

It would be difficult to imagine a situation where the factors enunciated in the *Wilshire Oil* case have more applicability than to the regulation before the Court, because (1) it deals with "the highly technical and involved facts entering into a practical solution of the problem of depletion"; (2) its solution was expressly left by Congress to the Commissioner probably because the problem is so technical and is essentially administrative in character; and (3) it has remained unchanged for twenty-five years, relied upon by the Commissioner and taxpayers alike. In this posture only overwhelmingly important considerations can serve to invalidate the regulation.

2. Petitioners contend (Br. 24–31) that the depletion deductions in effect since 1918 are not related to or designed to compensate for the physical exhaustion of the depletable property and therefore are not hinged on production, but are merely designed to permit recovery of taxpayers'

investment out of income. They conclude that this purpose will be fully accomplished by the adjustment of the basis downward (whether by actual depletion or by anticipated depletion that does not occur) until the taxpayer ends up with a zero basis, after which no further deductions will be allowed, thus protecting the revenues.

Assuming the correctness of the premise, it is difficult to see how the revenues of the Government would be protected by a device which would permit income to escape taxation with no assurance that it would be recouped from a future sale of the property at a profit over the reduced basis.[10]

But the fundamental error is in the premise. It is not true that the 1918 Act and subsequent statutes are not designed to compensate for physical exhaustion of the mineral reserve. These statutes deal with "depletion" as did those that preceded them, and there is nothing in the legislative history to indicate that Congress meant to provide for a totally different kind of allowance. H. Rep. No. 767, 65th Cong., 2d Sess., p. 10 (1939–1 Cum. Bull. (part 2), 86, 93); S. Rep. No. 617, 65th Cong., 3rd Sess., p. 8 (1939–1 Cum. Bull. (part 2), 117, 122); H. Conf. Rep. No. 1037, 65th Cong., 3rd Sess., p. 50 (1939–1 Cum. Bull. (part 2), 130, 136). What was accomplished by the 1918 Act, apart from provision for depletion

[10] See discussion, *infra*, pp. 24–26.

based on discovery value, was a removal of limitations imposed under earlier Acts which did not insure full compensation for the cost of mineral actually removed, and the delegation to the Commissioner of authority to adopt regulations which would effect such an allowance.[11] There is nothing in the whole history of depletion allowances that suggests that depletion is not compensation for exhaustion.

As this Court has often recognized under all of the Revenue Acts (*United States* v. *Ludey*, 274 U. S. 295; *Anderson* v. *Helvering*, 310 U. S. 404; *Helvering* v. *Bankline Oil Co.*, 303 U. S. 362), the function of the depletion deduction is to

[11] Under Section II B of the Revenue Act of 1913, c. 16, 38 Stat. 114, 167–168, the allowance was 5% "of the gross value at the mine of the output" for the year for which the computation was made. This Court recognized in *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, that that allowance was inadequate, but held the statute not invalid for that reason, since a depletion allowance is a matter of grace. See also *Burnet* v. *Thompson Oil & Gas Co.*, *supra*. No allowance need be granted, for the reason that the proceeds of mining and oil operations are not proceeds of the sale of property but gross income. *Stratton's Independence* v. *Howbert*, 231 U. S. 399; *Von Baumbach* v. *Sargent Land Co.*, 242 U. S. 503. Section 5 (a) Eighth (b) of the Revenue Act of 1916, c. 463, 39 Stat. 756, gave to the Secretary of the Treasury authority to make regulations providing for "a reasonable allowance" subject to the qualification that "the allowance" should not "exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made * * *." The 1918 Act removed the qualification and, in addition, provided for discovery depletion.

compensate the owner of the mineral-in-place for the wasting away of his capital asset. When there is production, there is a wasting away; without production there is none. Thus if there were no production there would be no need for depletion deductions.[11a]

Petitioners do not dispute the foregoing facts but seek rather by emphasis on certain provisions of the regulations to obscure them. And it is the regulations, not the statute, on which petitioners must rely for the apparent departures from a wholly logical structure on which they base their charge that depletion is to no degree keyed to production. The statute affords them no support. Since 1918 it has been without variation herein material (Sec. 23 (m), Revenue Act of 1936, Appendix A, *infra*, p. 40):

> "*Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, * * *."

[11a] Authorization of percentage depletion emphasized rather than altered the fundamental theory of the allowance. *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459, 467. In fact, the petitioners "investment" theory breaks down completely under percentage depletion, for such depletion continues after the investment has been recovered from income.

It is from the regulations implementing this provision and particularly from those applying to advance royalties that petitioners draw ammunition to attack that other provision in the regulations which is onerous to them.

The regulations, first promulgated under the 1918 act, established a system regarding the treatment of advance royalties designed to work most equitably in the majority of cases. Thus, in recognition of the fact that where advance royalties have been paid production will usually eventually be begun, provision was made that depletion deductions could be taken from such advance royalties without awaiting actual production. But provision had to be made as well for the exceptional case where production did not ensue. Instead of providing for a revision of the depletion deduction in earlier years, many of which would be barred by the statute of limitations, and in line with the treatment accorded similar problems, such as amounts released from reserve accounts (see *Maryland Casualty Co.* v. *United States,* 251 U. S. 342, 351–352),[12] provision was made that in the event no production occurred the taxpayer should add back to income in the year nonproduction became certain, amounts equal to the depletion deductions taken on the advance royalties. These provisions represent an integrated scheme established by the Commis-

[12] See also the comparable treatment in an analogous problem upheld in *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, and cases discussed, *infra*, p. 30.

sioner pursuant to specific statutory mandate, and as observed above there is considerable reason for belief that Congress is satisfied with it.

In its primary aspect, that of allowing depletion deductions in advance of production, this integrated scheme has been upheld and interpreted in *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, and *Herring* v. *Commissioner,* 293 U. S. 322. Petitioners now seize upon these decisions to tear apart the integrated scheme: thus, they argue (Br. 14–21) from these decisions that they have a right under the statute to deduct depletion in advance of production, and they conclude that as the regulation here involved would qualify that right it is invalid. A fatal weakness in their argument is that it is the regulation, approved in those decisions, and not the statute except derivatively which gives them the right to advance depletion, and under that regulation the right is not absolute but is qualified by the provision they now attack.

The statute, which leaves the details of the scheme to the Commissioner, would thus not have been offended had the regulations chosen to deny all depletion deductions on advance royalties until production had begun and then to permit the deductions to be taken cumulatively. Such a solution would have avoided the problem herein presented, but at the expense of working some injustice through wasted deductions on lessors on whose properties production is eventually begun,

who doubtless are a more numerous class than persons such as petitioners. Had such a solution been chosen petitioners would have had no depletion deductions at all, which forcibly demonstrates that petitioners' right to the deduction flows not from any command of the statute but from the regulations embodying the administrative scheme.

The keystone on which petitioners base their argument, *Murphy Oil Co.* v. *Burnet, supra,* shows clearly that while taxpayers have the right to depletion deductions from advance royalties, that right stems from the regulations. The whole question there was whether the regulations could validly require the deduction to be taken in advance of production. This Court considered the integrated scheme presented in the regulations and concluded that it represented a fair solution of the problem the Commissioner had to contend with. And the Court referred (287 U. S. 299, 306–307) to the provisions herein involved, and observed with evident approval that they completed the pattern. We submit that the Tax Court correctly gave great weight to this opinion, for in concluding that the integrated scheme represented a fair solution to the problem the Court necessarily considered and approved the essential component herein under attack.[13]

[13] Petitioners erroneously contend (Br. 10) that the statement in *Herring* v. *Commissioner*, 293 U. S. 322, 328—

> As to income tax liability in the year of termination of the lease, on account of bonus paid at the execution

3. One of the major contentions of petitioners directed against the validity of the regulation is that (Br. 14)—

> The Untaxed Royalties of Prior Years were Capital Recoveries in Those Years Under Sections 23 (m), 114 (b) (1), and 113 (b) (1) (B), Resulting in Permanent Reduction of Basis and Hence Cannot Be Treated as Income for Any Year or Years; * * *.

This position is based, in part, on the erroneous assumption already discussed that Section 23 (m) unconditionally allows depletion on advance royalties irrespective of production.

The argument grounded on the basis provisions of the statute is equally without support. There is nothing in Section 23 (m), Section 113, or Section 114 which precluded the Commissioner from

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of the lease, if no mineral has then been extracted, we express no opinion.

makes it clear that the *Murphy Oil Co.* opinion was not a holding on the validity of Article 23 (m)–10 (c). The *Herring* case involved percentage depletion, whereas cost depletion is involved here (R. 46) and was involved in the *Murphy Oil* case. Percentage depletion and its relation to paragraph (c) raises problems not common to cost depletion (see dissenting opinion of Judge Hutcheson in *Crabb* v. *Commissioner*, 119 F. 2d 772, 774–776 (C. C. A. 5th)), although the Commissioner has taken the position that (c) applies to percentage depletion (G. C. M. 14448, XIV–1 Cum. Bull. 98, 100–101 (1935), Appendix B, *infra*, pp. 46–51), and this position has been sustained by the courts. *Crabb* v. *Commissioner*, *supra*; *Sneed* v. *Commissioner*, *supra*; *Houston Farms Development Co.* v. *United States*, *supra*.

requiring by regulation that amounts such as are here involved should be taxed as income and simultaneously restored to capital account as a basis for any future depletion. Section 23 (m) of the Revenue Act of 1936 provides in part that—

> In any case in which it is ascertained *as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof,* then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. * * * [Italics supplied.]

While petitioners admit, as indeed they must, that this provision does not apply "directly" to their case, they urge that it establishes a Congressional intention that the depletion basis should not be restored on cancellation of a lease without production (Br. 18–19).

We submit that not only is the provision plainly inapplicable here, but the legislative history makes it clear that Congress, in adopting the above provision, did not contemplate situations beyond the class carefully described in the statutory language.[14] Moreover, the attempt to at-

[14] This provision of Section 23 (m) first came into the Revenue Acts as Section 23 (l) of the Revenue Act of 1932. The Report of the Senate Finance Committee (S. Rep. No.

tribute to the statutory language a definite policy prohibiting an adjustment of basis for any reason is contrary to the broad discretion delegated to the Commissioner to provide "a reasonable allowance for depletion." This conclusion is reinforced by the essentially different problems posed by incorrect estimates of the number of recoverable units and cancellation of a lease without production. In the former situation, by hypothesis, there has been production as a result of which it is known with greater certainty that more or less units will be recovered than previously estimated. The adjustment provided by Section 23 (m) in the case, for example, of a prior underestimate of recoverable units is fair to the Government and taxpayer alike since by decreasing the amount of depletion attributable to each unit of future production, depletion will equal extraction. But when, as in the instant case, there is cancellation of a lease without any production, although the lessee has made large payments in royalties, it will often be the case that there will never be extraction because no minerals exist or none exist in

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665, 72d Cong., 1st Sess., p. 16 (1939–1 Cum. Bull. (Part 2), 496, 507–508) accompanying that Act, states:

"The House bill requires a change in the annual depletion allowance where a new estimate of the number of the recoverable units is made in the light of subsequent events. The effect of the amendment is shown by the following example:

"A purchased for $1,000 an ore body with estimated recoverable units of 1,000. He removes 500 units and takes

commercial quantities."[18] To say that the Government-taxpayer account will be adjusted in such cases by reducing the amount of depletion attributable to each unit of mineral extracted in the future is to allow depletion where none has been suffered or ever will be. In view of the Congressional purpose in providing for depletion deductions, such an allowance would be unreason-

depletion deductions aggregating one-half of his cost, or $500. Subsequently it is ascertained that there remain in the mine 1,500 recoverable units and the original estimate of 1,000 recoverable units is revised. Under the amendment, his unrecovered cost ($1,000 less $500) would be spread over the revised estimate of the recoverable units (1,500) with the result that on each unit thereafter removed he would be allowed a depletion deduction of 33⅓ cents per unit instead of $1 per unit.

"The provision in the House bill has been amended so as to make it clear that it is also to apply where the revision of the estimate of recoverable units results from day-to-day operations."

See also Report of the Conference Committee (H. Conference Rep. No. 1492, 72d Cong., 1st Sess., p. 11 (1939–1 Cum. Bull. (Part 2) 539, 540). The explanation of the amendment in the House of Representatives by Congressman Vinson confined its scope to the situation described in the Senate Report. 75 Cong. Record, Part 7, p. 7233.

[18] This is in part recognized by petitioners who state (Br. 15, fn. 13):

"It should be noted that, although the termination of a lease is a serious economic blow to the property, such termination, in the case of a proven mine, does not destroy anticipation of future production."

But often unproven mines are leased, as may have been the situation here so far as the record indicates. And even so-called "proven" mines may turn out to have far less than the anticipated deposits.

able. Accordingly, the clause of Section 23 (m) on which petitioners rely in no way limited the Commissioner's authority to provide a "reasonable allowance for depletion," and, if at all relevant here, suggests that he did not exceed his authority in providing in Article 23 (m)–10 (c) that—

> If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed * * *.

Contrary to petitioners' argument (Br. 15–18) this provision is also not inconsistent with the basis provisions of the statute contained in Sections 113 and 114 of the Revenue Act of 1936, but rather finds authorization in them. Section 114 (b) (1), (Appendix A, *infra*, p. 42), as petitioners agree (Br. 17), provides that the basis upon which depletion is to be allowed shall be the adjusted basis provided in Section 113 (b). They argue from Section 113 (b) (1) (B), (Appendix A, *infra*, p. 41), that to the extent that depletion deductions have been taken in previous years, basis is permanently reduced because Section 113 (b) (1) (B) provides that proper adjustment shall be made in all cases for depletion "to

the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws." But they completely disregard Section 113 (b) (1) (A) (Appendix A, *infra*, p. 41), which provides that *proper adjustment* in respect of the property shall *in all cases be made*—

> for expenditures, receipts, losses, or other items, properly chargeable to capital account, * * * but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years.

This provision clearly allows an adjustment to basis because depletion deductions previously taken fall within the phrase "other items, properly chargeable to capital account," when no extraction will occur because of cancellation of a lease. We have pointed out that depletion is an allowance for a decreasing capital investment in the minerals in place. The propriety of adjusting the capital account to reflect the fact that the capital investment remains intact where there has been no extraction seems obvious. And that is exactly what the Commissioner has done in Article 23 (m)–10 (c). As a matter of mechanics, particularly in a case where there has been some production, the depletion deductions allowed or allowable stand as an adjustment to the original basis, but there is an offsetting adjustment for

the amount taken which, in fact, represented no exhaustion and is required to be reported as income. Whether subsection B is construed as imposing a limitation on subsection A or permitting an offsetting adjustment is immaterial, since the result in either case is the same.

If any doubt remains whether such adjustment made by the regulation is within the contemplation of Section 113 (b) (1) (A), it is resolved by the opinion of the Court in *Dobson* v. *Commissioner*, Nos. 44–47, decided December 20, 1943, rehearing denied, February 14, 1944, not yet reported. The Court there said:

> The argument relies upon § 113 (b) (1) (A) of the Internal Revenue Code, which provides for adjusting the basis of property for "expenditures, receipts, losses, or other items properly chargeable to capital account." This provision, it is said, requires that the right to a deduction for a capital loss be treated as a return of capital. Consequently, by deducting in 1930 and 1931 the entire difference between the cost of his stock and the proceeds of the sales, taxpayer reduced his basis to zero. But the statute contains no such fixed rule as the Government would have us read into it. It does not specify the circumstances or manner in which adjustments of the basis are to be made, but merely provides that "Proper adjustment * * * shall in all cases be made" for the items named if "properly chargeable to

capital account." What, in the circumstances of this case, was a proper adjustment of the basis was thus purely an accounting problem and therefore a question of fact for the Tax Court to determine. Evidently the Tax Court thought that the previous deductions were not altogether "properly chargeable to capital account" and that to treat them as an entire recoupment of the value of taxpayer's stock would not have been a "proper adjustment." We think there was substantial evidence to support such a conclusion.

If, in the *Dobson* case, in the absence of a regulation, the Tax Court had broad authority to determine what constituted a proper adjustment to capital account under Section 113 (b) (1) (A), obviously the Commissioner here had equally broad authority to issue regulations providing for proper adjustments to capital account in such a case as this one. This is particularly true here, because the problem cannot be divorced from that of providing for "a reasonable allowance for depletion," the exact formula for which Congress purposely and expressly left to the Commissioner.[16]

4. The regulation is not unreasonable on the ground argued by petitioners (Br. 31–41), that it taxes income in a year in which no cash or other

[16] The Court in *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 306–307, in effect approved the Commissioner's method of making "necessary capital readjustments."

property is received. In other analogous situations and independently of regulations, the courts have held that income [17] is realized in the year in which the character of an earlier payment is first determined and in many instances no money or other property was received in the tax year. *Maryland Casualty Co.* v. *United States*, 251 U. S. 342; *Helvering* v. *Bruun*, 309 U. S. 461; *Doyle* v. *Commissioner*, 110 F. 2d 157 (C. C. A. 2d), certiorari denied, 311 U. S. 658; *Commissioner* v. *Dallas Title & Guar. Co.*, 119 F. 2d 211 (C. C. A. 5th); *Warren Service Corp.* v. *Commissioner*, 110 F. 2d 723, 724 (C. C. A. 2d); *Virginia Iron Coal & C. Co.* v. *Commissioner*, 99 F. 2d 919 (C. C. A. 4th), certiorari denied, 307 U. S. 630; *Baird* v. *United States*, 65 F. 2d 911 (C. C. A. 5th), certiorari denied, 290 U. S. 690; *Bourne* v. *Commissioner*, 62 F. 2d 648 (C. C. A. 4th), certiorari denied, 290 U. S. 650.

Petitioners' argument (Br. 42–43) that the regulation is at variance with Sections 41 and 42 of the Revenue Act of 1936, providing that net income is to be computed on the basis of the taxpayers' annual accounting period, and the decision of the Court in *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359, is based on a fundamental misconception of the income concept in federal taxation as just explained. Their understanding ap-

[17] As used in Section 22 (a) of the Revenue Act of 1936 and identical sections in other acts.

parently is that income is only realized in the year when money is received. But since, as we have shown, income was received when it was finally known that the amounts received in earlier years were clear profit and not reimbursement for the wasting mineral reserve, the inclusion in income in 1937 is a consequence of, and not inconsistent with, the annual structure of the income tax.

But even if the regulation did depart from the annual accounting structure of the Revenue Act as embodied in Sections 41 and 42, it is no objection to its validity because Section 23 (m) delegated to the Commissioner the authority to prescribe the method of determining "a reasonable allowance for depletion." And if in so doing he departed from the annual system, it would be within the broad authority conferred by Section 23 (m).[18]

Petitioners' complaint that the regulation imposes a "penalty" (Br. 31–41) is also based on their misapprehension of the income concept. There is a "penalty" only if what was income in a series of previous years is arbitrarily put in in-

[18] Petitioners inconsistently argue (Br. 13) that a more equitable solution of the problem lies in the Commissioner using his regulation-making power to open up the statute of limitations and restore to income amounts equal to depletion deductions for the years in which the deductions were taken. Such a solution would be as inconsistent with Section 275 (a) of the Revenue Act of 1936, providing for a three-year period of limitation, as is paragraph (c) with Sections 41 and 42, even if petitioners' analysis were correct.

come in the tax year. But as we have shown, the amounts equal to the depletion deductions did not become income until 1937.[19] The result is not only not a penalty, but any other result would permit income to escape taxation. In any event, as both the Board (R. 49–50) and Circuit Court pointed out (R. 80–81), the so-called hardship is not a necessary result of the regulation. If the taxpayers had had large incomes in the years of depletion deductions and a small income in 1937, they may well have had an over-all tax saving. Similarly, if there had been a period of falling tax rates, the result may have been reversed. Again, the argument amounts to a complaint directed at the annual system of taxation which necessarily operates to impose a large tax in the year when a large amount of income is realized with no necessary relation to the periods to which under some other system the income might be attributed.

II

THE REGULATION IS VALID WITHOUT TAX BENEFIT QUALIFICATION

1. In reaching the conclusion that amounts equal to depletion deductions in prior years were income in 1937, the Board excluded the sum of

[19] Amounts actually received in several other years were included in income in one year in *Doyle* v. *Commissioner, supra; Virginia Iron Coal & C. Co.* v. *Commissioner, supra;* and *Commissioner* v. *Dallas Title & Guar. Co., supra.*

$4,958.05 deducted in 1937 by Mrs. Douglas because she sustained a net loss in 1933 and therefore had received no tax benefit from the deduction. (R. 52.) The Circuit Court of Appeals, we submit, properly concluded (R. 81) "That it [tax benefit principle] is not in accordance with law, making it our duty to reverse under the statute. 26 U. S. C. § 1141 (c) (1), Supp. 1939." It is a question of law because Article 23 (m)–10 (c) provides that—

> the lessor shall adjust his capital account by restoring thereto the *depletion deductions* made in prior years * * *, and a *corresponding amount* must be returned as income * * * [Italics supplied.]

Clearly the language of the regulation is not susceptible of "tax benefit" qualification. Cf. *Virginian Hotel Corp.* v. *Helvering,* 319 U. S. 523.[20] The problem here is therefore essentially that of Point I, *supra,* namely, the validity of the regulation. As such the considerations which we urged there are equally apropos.

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[20] There it was held that excessive depreciation taken in earlier years reduced the depreciation basis regardless of tax benefit where the statute provided that the basis for depreciation is cost of property with adjustments for depreciation to the extent "allowed (but not less than the amount allowable)." The majority was of the opinion that any deduction taken, if not challenged by the Commissioner, was "allowed." *A fortiori* since the regulation provides that an amount equal to the "depletion deduction" is income, it cannot be interpreted as being limited by the tax benefit concept.

Reliance on *Dobson* v. *Commissioner,* Nos. 44–47, decided December 20, 1943, rehearing denied, February 14, 1944, not yet reported (Br. 61–62), to support the application of the tax benefit qualification is misplaced. The Court there emphasized that "We are not adopting any rule of tax benefits." What it did hold, to use the Court's language, was that—

> We only hold that *no statute or regulation having the force of one* and no principle of law compels the Tax Court to find taxable income in a transaction where as *matter of fact* it found no economic gain and no use of the transaction to gain tax benefit. * * * [Italics supplied.]

In this case a regulation is in force which in unambiguous terms required, without qualification as to tax benefit, that amounts equal to the depletion deducted in previous years with respect to advance royalties are to be included in income when the lease is terminated without extraction. The Tax Court was therefore compelled to hold that even though Mrs. Douglas derived no tax benefit from depletion allowed with respect to advance royalties in 1933, an amount equal to that depletion must be returned as income in 1937, unless the regulation lacked the force of law because inconsistent with the statute.

Whether it was inconsistent with the statute is

a pure question of law.[21] The *Dobson* opinion expressly safeguards Treasury Regulations from modification by the Tax Court based on its opinion as to what constitutes a better rule.[22] Yet

[21] Even if the case involved a preliminary question whether the regulation properly interpreted excluded the tax benefit theory, the question would still be a question of law. The question of the construction and interpretation of the regulations is one which Congress specifically intended the Circuit Court of Appeals to review. The House Report on the Revenue Bill of 1926 expressly states that the Circuit Court of Appeals "upon review may consider, for example, questions as to * * * the proper interpretation and application of * * * any regulation having the force of law * * *." H. Rep. No. 1, 69th Cong., 1st Sess., pp. 19–20 (1939–1 Cum. Bull. (Part 2) 315, 328–329).

On this question the *Dobson* opinion itself states:

"It is contended that the applicable statutes and regulations properly interpreted forbid the method of calculation followed by the Tax Court. If this were true, the Tax Court's decision would not be 'in accordance with law' and the Court would be empowered to modify or reverse it. Whether it is true is a clear-cut question of law and is for decision by the courts."

Cf. *The Security Flour Mills Co.* v. *Commissioner*, No. 276, decided February 28, 1944.

[22] Moreover, any practical considerations which may have influenced the Court not to disturb the Tax Court's decision in the *Dobson* case do not exist where a regulation is involved. The Bureau of Internal Revenue, not the Tax Court, is the administrative agency charged with the adoption of rules and regulations to implement and interpret the tax laws. It is staffed to perform that duty and has had long experience in that field. The Tax Court has been given no authority to adopt regulations of its own or to modify regulations issued by the Commissioner and is not functionally qualified for such an undertaking. Its power of review with respect to regulations is precisely the same as that of the courts, namely, to determine whether the regulation is consistent with the statute.

that is precisely what the Tax Court has done in this case.

2. There remains to consider the reasonableness of Article 23 (m)–10 (c) from the point of view of its failure to incorporate the tax benefit theory. This has been largely answered by the discussion in Point I. For reasons there stated the statute did not require that any depletion be allowed with respect to the advance royalties before extraction. *A fortiori* it did not require that if such an allowance were made, it could be made conditional on the restoration of the amounts to income in the year of termination of the lease without extraction, only to the extent that a tax benefit was derived in the years of the depletion allowances. Petitioners complain (Br. 61, 63) that since the only reason for including the amounts in question in income in 1937 is that they were not entitled to the depletion deductions previously taken, there is no justification for including any of the amounts in income that did not serve to reduce tax liability. But, as we have emphasized, the amounts should be included in income in 1937, not to correct an earlier error but because in that year they were for the first time realized income. The contingency, extraction of ore, was eliminated by cancellation of the lease and income was for the first time realized. See *Maryland Casualty Co.* v. *United States, supra; Helvering* v. *Bruun, supra;* and *Doyle* v. *Commissioner, supra.* Whether the taxpayer received a

tax saving in the years in which that part of the royalties which represented depletion were in effect excluded from income, is, on this analysis, incapable of altering the status of the amounts as income in 1937.

The Board's error in reaching a contrary conclusion is shown by its reason for applying the tax benefit theory which is in its language as follows (R. 52):

> Where there is recovery in respect of a loss sustained in an earlier year and a deduction of such loss claimed and allowed for the earlier year had effected an offset in taxable income, the amount recovered in the later year should be included in taxable income for the year of recovery, *the reason being that even though the subsequent recovery is in the nature of a capital recovery the prior deduction of the amount of the loss from taxable income has for income tax purposes already given the taxpayer a recoupment of said loss out of taxable income and the subsequent recovery, being in the nature of a replacement of taxable income, is equivalent to gain to the taxpayer. National Bank of Commerce of Seattle* vs. *Commissioner*, 115 Fed. (2d) 875, affirming 40 B. T. A. 72. But where the deduction claimed and allowed in the prior year did not effect an offset of taxable income, the amount recovered in a later year does not constitute taxable income for the year of recovery. *Estate of James N. Collins, supra.* [Italics supplied.]

The theory that a loss recovery is treated as income although actually it is a return of capital, because *taxwise* the capital was recouped to the extent of a tax benefit, has no applicability to the facts of this case. The amounts here involved were income not because of a prior capital recoupment taxwise, but because their status as income first became established in the tax year. On the Board's analysis properly applied there was no recoupment of capital in the tax year but a realization of income. Accordingly, even were there not a controlling regulation, the Board must be reversed because its decision is without support in the record.

3. Petitioners state that in 1934, Bessie P. Douglas received no tax saving from $839.90 of her depletion deduction (Br. 62) and similarly in 1932, the estate of Charles H. Robinson received no tax reduction as a result of $379.13 of the depletion deduction (Br. 63). It is contended from this that the amounts included in income in 1937 should be reduced, *pro tanto*. For the reasons set forth with respect to Mrs. Douglas' 1933 deduction such considerations are irrelevant.

Even if the Court should disagree with us as to that situation there are additional considerations for not reducing taxable income in 1937 where there was net income after deductions, though no tax saving resulted. The Board found with respect to the 1934 depletion deduction of Mrs. Douglas and the 1932 deduction of Robin-

son's estate that income was offset (R. 52). Thus the Board refused to give effect, in determining tax benefit, to the credits each had in the years in question. There is statutory justification for the treatment. Whatever the similarity in practical effect between a deduction and a credit in a given case, the statute plainly distinguishes between the two. The deductions offset gross income. The credits are subsequently taken into account in the computation of the tax. The statutory scheme treats the deductions as offsetting the gross income, not the credits. We can perceive no basis for treating the credits as having this effect. In any event it cannot be said that the Board's treatment of the problem was without legal justification. *Dobson* v. *Commissioner, supra.* In that case the Court refused to go behind the Tax Court's conclusion on this very issue.

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted.

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APPENDIX A

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that—

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—

(A) for expenditures, receipts, losses, or other items, properly chargeable to capital account, including taxes and other carrying charges on unimproved and unproductive real property, but no such adjustment shall be made for taxes or other carrying charges for which deductions have been taken by the taxpayer in determining net income for the taxable year or prior taxable years;

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

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SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

(1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (m)–10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*

(a) If a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the basis for depletion as provided in section 114 (b) (1) or (2) which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the lessor's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(b) If the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase

price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, an amount equal to that part of the basis for depletion allocable to the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

(d) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ percent of the amount thereof; and the lessors of sulphur mines, metal mines, and coal mines may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year beginning after December 31, 1935, for which he first makes

return in respect of the property (and for subsequent taxable years in case an election to have depletion computed on a percentage basis has been exercised in the proper return) 23 percent, 15 percent, and 5 percent, respectively, of the amount thereof; but the deduction shall not in any case exceed 50 percent of the net income of the taxpayer (computed without allowance for depletion) from the property.

ART. 23 (m)–11. *Depletion and depreciation accounts on books.*—Every taxpayer claiming and making a deduction for depletion and depreciation of mineral property shall keep accurate accounts in which shall be recorded the cost or other basis provided by section 113 (a), as the case may be, of the mineral deposit and of the plant and equipment, together with subsequent allowable capital additions to each account and all of the other adjustments required by section 113 (b).

If the plan or method of depletion and depreciation accounting adopted by the taxpayer has once been approved by the Commissioner, it cannot be changed by the taxpayer without the consent of the Commissioner. These accounts shall thereafter be credited annually with the amounts of the depletion and depreciation computed in accordance with articles 23 (m)–2, 23 (m)–3, 23 (m)–4, or 23 (m)–5; or the amounts of the depletion and depreciation so computed shall be credited to depletion and depreciation reserve accounts, to the end that when the sum of the credits for depletion and depreciation equals the cost or other basis of the property, plus subsequent allowable capital additions, no fur-

ther deductions for depletion and depreciation with respect to the property shall be allowed, except such depletion deductions as may thereafter be allowable under section 114 (b) (2), (3), or (4) and articles 23 (m)–3, 23 (m)–4, or 23 (m)–5.

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APPENDIX B

G. C. M. 14448, XIV–1 Cum. Bull. 98 (1935):

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I

The opinion of the court in *William E. Herring* v. *Commissioner,* supra (which arose under the Revenue Act of 1926), may be summarized as follows:

1. A bonus is payment in advance for oil and gas to be extracted (advance royalty) and is, therefore, taxable income (*Burnet v. Harmel,* 287 U. S. 103, Ct. D. 611, C. D. XI–2, 210; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, Ct. D. 619, C. B. XII–1, 231; and *Bankers Pocahontas Coal Co.* v. *Burnet,* 287 U. S. 308); as such, it is a part of the "gross income from the property" as that phrase is used in section 204 (c) 2 of the Revenue Act of 1926 to designate the *base* for the application of the percentage depletion deduction. Given "gross income from the property," which is the *base,* and the authority as provided in section 204 (c) 2, in the case of oil and gas wells, to compute the depletion allowance at a percent of such base, the question whether the amount so computed comes within the *grant* in the statute (section 214 (a) 9 of the Revenue Act of 1926, for the purposes of this case) of "a reasonable allowance for depletion" is not controlled by the fact that there was no extraction of oil or gas in the

year for which the allowance is claimed, or by the fact that in such year there was no practical assurance of production in the future.

2. The conditions prescribed for the allowance of bonus depletion on the cost basis and on the percentage of income basis must be the same for the reason that "the nature and purpose of the allowance is the same in both cases." (*United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459.)

3. The grant as a deduction from gross income of a reasonable allowance for depletion "in the case of oil and gas wells" has been the same under all the Revenue Acts, 1916 to 1934, inclusive. As to *cost depletion,* the regulations of the Bureau under the Revenue Act of 1926 and prior Revenue Acts treated a bonus or advance royalty as subject to depletion and those regulations have been approved by the reenactment of the statutory provisions without alteration. (*Murphy Oil Co.* v. *Burnet,* supra.) "It has never been held here [in the Supreme Court] that the existence of a well conditioned the allowance. Nor, until recently, has the Treasury so ruled." The situation presented by recent administrative rulings (including decisions of the Board of Tax Appeals) is that if the taxpayer computes depletion upon the basis of cost or March 1, 1913, value, he may deduct depletion from a bonus payment irrespective of the sinking of a well or the production of any oil or gas (see regulations of the Bureau discussed in *Murphy Oil Co.* v. *Burnet,* supra); but if the taxpayer elects to avail himself of the alternative method of computing the deduction at a per cent of gross income, "though the

nature of the deduction is unchanged" (*United States* v. *Dakota-Montana Oil Co.*, supra), he is not entitled to any deduction for depletion unless there is production within the taxable year, no matter how small such production may be. However, if there is a *base* provided by statute for the computation of the allowance, it is improper in the one case, i. e., when computed on the percentage of income basis, to condition the bonus depletion allowance by the test of actual production, or the imminent probability of production, or by any refinements as to the degree of probability of future production, and at the same time to allow the deduction if computed on *the cost basis* "irrespective * * * of the production of any oil or gas." The court concluded that there is no "statutory authority or logical justification for withholding it in the one and granting it in the other."

4. Therefore, a depletion deduction on the percentage of income basis is allowable against a bonus payment in the year of the receipt of the payment irrespective of the fact that in such year "there was no extraction of oil or gas, and no practical assurance of production in the future."

II

The purpose of the depletion allowance on the *cost* basis is to provide for the return to the owner of mineral deposits, whether freehold or leasehold, *the value of his property on the basic date* (plus subsequent allowable capital additions), "but not including land values for purposes other than the extraction of minerals." (See article 201, Regulations 69, and the

corresponding provisions of subsequent regulations.) Therefore, a condition precedent to the allowance of bonus depletion on that basis (under article 216 (a), Regulations 69, and the corresponding provisions of subsequent regulations) is a determination of a mineral value in the property at the date of acquisition (if depletion is to be based on *actual cost*), or at a basic date otherwise prescribed by law (as in the case of depletion based on March 1, 1913, value). If no mineral value in the leased premises can be shown as of the basic date, there is no capital sum returnable through depletion and there is *no base* for the allowance of depletion against a bonus payment or any other income from mineral extraction. From this there was developed the administrative rule set forth in I. T. 2361 (1927) (C. B. VI–1, 73), to the effect that article 216 (a), of Regulations 69 (relating to bonus depletion), has no application to a bonus received by the lessor of an *unproven area* and is applicable only to a lease of property in a *proven area* where the mineral content was capable of being estimated at the time the bonus was received even though the property was nonproducing at that time. If, at the time of the execution of the lease, the leased premises were in an unproven area, it follows that a mineral value at the basic date can rarely, if ever, be established. Where a mineral value can be established as of the basic date, a capital sum returnable through depletion can be ascertained at the execution of the lease, and, therefore, a bonus (being royalty in advance of extraction) may be treated as subject to depletion though it is received in advance

of actual production. (*Murphy Oil Co.* v. *Burnet,* supra.)

For the computation of depletion on the percentage of income basis, the *base* is the gross income from the property. Since the Supreme Court has held that a bonus received in advance of production is "gross income from the property" in the case of oil and gas wells, within the meaning of section 204 (c) 2 of the Revenue Act of 1926, and as such is a part of the *base* for the computation of the allowance, it follows that inasmuch as depletion may be allowed in anticipation of production, such a bonus is subject to depletion without the establishment of any other *base.* Under these circumstances, the distinction between bonuses for leases in proven and unproven areas (compare I. T. 2361, supra), which was carried forward by G. C. M. 11384, supra, and applied to claims for bonus depletion deductions on the percentage of income basis, cannot now be sustained. A depletion deduction on the percentage of income basis is, therefore, allowable in every case of a bonus payment received in advance of production. G. C. M. 11384 is hereby revoked.

III

In its opinion in *William E. Herring* v. *Commissioner, supra,* the Supreme Court made the statement that it expresses no opinion as to whether the amount allowed as a depletion deduction from the bonus payment in the year of the execution of the lease may be taxed as income to the lessor in the year of the termination of the lease where there has been no extraction of mineral from the leased premises. The allow-

ance of the deduction in the year of the execution of the lease rests upon an anticipation of production to avoid "the attendant inconvenience of indefinite postponement," as was said in *Murphy Oil Co.* v. *Burnet, supra.* The grant of the deduction is in any case upon the ground of "a reasonable allowance for depletion." If on the termination of the lease there has been no production, then there has in fact been no depletion. Ordinarily the Government may recoup only by restoring the deduction to income and asserting the tax against the taxpayer in the year of the termination of the lease. *Cost* depletion on an advance royalty has always been allowed on condition that if the anticipated production does not materialize, the taxpayer will restore the amount of the deduction to income as of the year the lease terminates, expires, or is abandoned. (See article 216 (b) and (c), Regulations 69, with which all prior and subsequent regulations are identical.) Since the "nature and purpose of the allowance is the same," as the Supreme Court has pointed out, whether the deduction be computed on the cost basis or on a percent of the gross income from the property, it follows that the taxpayer must be deemed to have taken the bonus depletion deduction on the percentage-of-income basis on the condition that he will restore the amount to such deduction to income as of the year of the termination of the lease where there has been no production from the leased premises.

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